Co-operative and competitive enforced self regulation: the role of governments, private actors and banks in corporate responsibility

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ABSTRACT

In considering why practices which stimulate incentives for private agents to exert corporate control should be encouraged, this paper highlights criticisms attributed to government control of banks. However the theory relating to the "helping hand" view of government is advanced as having a fundamental role in the regulation and supervision of banks. Furthermore, governments have a vital role to play in corporate responsibility and regulation given the fact that banks are costly and difficult to monitor – this being principally attributed to the possibility that private agents will lack required incentives or the ability to supervise banks. Through its supervision of banks, governments also assume an important role where matters related to the fostering of accountability are concerned – not only because banks may have the power to affect firm performance, but also because some private agents are not able to afford internal monitoring mechanisms.

Through the Enforced Self Regulation model, the paper attempts to highlight the role played by government in the direct monitoring of firms. In proposing the Co-operative and Competitive Enforced Self Regulation model, it attempts to draw attention to the fact that although such a model is based on a combination of already existing models and theories, the absence of effective enforcement mechanisms will restrict the maximisation potential of such a model.

The primary theme of the paper relates to how corporate responsibility and accountability could be fostered through monitoring and the involvement of governments in the regulation of firms. It illustrates how structures which operate in various systems, namely, stock market economies and universal banking systems, function (and attempt) to address gaps which may arise as a result of lack of adequate mechanisms of accountability. Furthermore it draws attention to the impact of asymmetric information (generally and in these systems), on levels of monitoring procedures and how conflicts of interests which could arise between banks and their shareholders, or between governments and those firms being regulated by the regulator, could be addressed.

Key words: accountability, asymmetric information, universal banking, regulation, regulatory capture, government.

Co-operative and Competitive Enforced Self Regulation: The Role of Governments, Private Actors and Banks in Corporate Responsibility.

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Introduction

"Optimal governance", it is contended, "requires a flexible mix of competition and co operation between governmental actors, as well as between governmental and non governmental actors."[2]

"Pigou's 1938 statement on regulation views monopoly power, externalities and informational asymmetries as creating a "constructive role" for the government to help offset market failures and encourage social welfare."[3] Such a view, known as "the helping hand view of government"[4], is contrasted with that of "the grabbing hand theory"[5] which is put forward by those who disagree with the helping hand view of government, who argue that governments do not frequently implement regulations to deal with market failures.[6] Furthermore such a theory predicts that governments focussing more on strengthening private sector control of financial institutions, namely, banks, are more likely to promote development within these institutions than governments taking a more hands-on approach to regulation.[7]

Law enforcers are admonished to be responsive to citizens' and /or corporations' abilities to effectively regulate themselves before deciding whether to increase their level of intervention.[8] Responsive regulation is not only regarded as a task which governments alone can undertake, but also one which private actors can perform – to the extent that they are also able to regulate governments responsively.[9]

This paper addresses how the involvement of governments, private agents (through private sector corporate control of banks and firms), and other actors such as standard setting bodies in financial regulation and supervision, contribute to corporate responsibility. It aims to highlight not only why the Enforced Self Regulation model is preferred to government or self regulation, but also the benefits of the Co-operative and Competitive Self Regulatory model over that of the model based on Enforced Self Regulation.

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[2] See DC Esty and D Geradin, „Regulatory Competition and Economic Integration: Comparative Perspectives" 2001 Oxford University Press at page 31

[3] See JR Barth, G Caprio Jr, and R Levine, "Bank Regulation and Supervision: What Works Best?" pp 1-2; see also AC Pigou, *The Economics of Welfare* (1938) 4th Edition London: MacMillan and Co

[4] „According to which governments regulate to correct market failures". See abstract, ibid.

[5] „According to which governments regulate to support political constituencies" ibid. See also A Shleifer and R Vishny *The Grabbing Hand: Government Pathologies and their Cures*, Cambridge, MA: Harvard University Press at page 47

[6] ibid

[7] ibid at page 2

[8] J Braithwaite, *Restorative Justice and Responsive Regulation* (2002) at page 29 also see N Gunningham and P Grabosky Smart Regulation: Designing Environmental Policy (1998) Oxford: Clarendon Press.

[9] J Braithwaite, *Restorative Justice and Responsive Regulation* (2002) at page 29

In considering why practices which stimulate incentives for private agents to exert corporate controls (such practices being facilitated under the Enforced Self Regulation Model) should be encouraged, the paper highlights criticisms attributed to government control of banks. However, it also points out the fact that banks are costly and difficult to monitor – this being principally attributed to the possibility that private agents will lack required incentives or the ability to supervise banks. Hence it highlights how the "helping hand" view of government could contribute in this respect. In so doing, it also draws attention to the fact that even though government control of banks has its weaknesses, a distinction should be drawn between both theories (the "helping hand view" of government and "the grabbing hand" theory) as a means of highlighting the role which government officials can assume in the regulation and supervision of banks.

The paper also highlights the benefits of government ownership of banks – as compared to government's mere supervision and regulation of banks. Such benefits of government ownership include the "extensive control" which it provides to the government in respect of the choice of projects being financed whilst leaving the implementation of these projects to the private sector and its contribution in helping the government to rectify failures which pose a threat to private capital markets.[10]

Section One draws attention to the principal advantage which Enforced Self Regulation is considered to have over Self Regulation, namely accountability, through an analysis of the advantages and disadvantages attributed to Enforced Self Regulation and Self Regulation. In drawing a comparison between stock market economies and universal banking systems, section two not only highlights how such systems, through certain structures, serve as accountability mechanisms, but also considers the impact of banks on firm performance – particularly in universal banking systems. Section three then highlights the conflicts of interest attributable to asymmetric information and introduces the concept of "regulatory capture". Furthermore, it makes reference to measures which have been implemented in certain jurisdictions – as means of resolving such conflicts of interest and issues related to asymmetric information. Section four highlights the benefits attributed to government ownership of banks, its capacity to address and rectify institutional failures which pose a threat to private capital markets, and how the issue of asymmetric distribution of information (between regulator and the regulated) has impacted jurisdictions dominated and not dominated by government ownership of banks. Section five addresses the role of state regulation in assisting to prevent banks from taking excessive risks. It does this by way of reference to the role played by the "helping hand view of government" in combating problems attributed to informational asymmetries. Within this context, it highlights the fact that even though benefits are derived from bank independence (independence from external control), government ownership of banks could assume an important function where a distinction is drawn between the "helping hand" and the "grabbing hand" theories. Section six then concludes with an introduction and analysis of the Co-operative and Competitive Enforced Self Regulation Model – with focus on why such a model is preferred to the Enforced Self Regulation model.

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[10] See R La Porta, F Lopez de Silanes and A Shleifer, "Government Ownership of Banks" 2000 Working Paper 7620 at page 3

A. Advantages and Disadvantages of Self Regulation

I. Advantages of Self Regulation

Some potential advantages of self regulation as identified by Coglianese and others are as follows:[11]

i) Proximity: Self regulatory organisations are considered to be closer to the industry being regulated. Such proximity not only provides them with greater access to more comprehensive and up-to-date information about a particular industrial sector, enables them to spot impending problems at a greater pace, but is also helpful within the context of rapidly changing sectors. This is contrasted with the situation involving government regulators who are considered to often find themselves in positions where they have to "catch up".

ii) Flexibility: Given the fact that self regulatory organisations are considered not to face "due process hurdles" and political constraints which government regulators are subjected to, such conditions accord them with greater flexibility and the ability to address "politically unpopular or extremely complex issues" which government regulators may be unwilling to address.

iii) Compliance: Self regulation is considered to have the potential to contribute to a higher level of compliance with rules since the involvement of industry in establishing those rules facilitates greater acceptance of such rules by individual firms. Another explanation put forward to explain why self regulation may facilitate compliance lies in the fact that self regulation is also considered to have the potential to "harness the collective interests of the industry".[12]

iv) Resources: Self regulatory bodies are considered to have greater potential to secure required facilities and funding – whose availability or use cannot be determined or impeded by bodies such as legislature."

II. Disadvantages of Self Regulation

Disadvantages also identified by Coglianese and others and attributed to self regulation include:[13] i)Conflicts of interest – which is attributed to "the very proximity which can help self regulators acquire useful information" – since knowledge of a particular industry does not necessarily imply that the incentives of the self regulator are projected in the right direction to enable such a regulator regulate more effectively ii) Inadequate sanctions: The advantage attributed to flexibility is also considered to have the potential to result in effective level of sanctions being imposed on serious perpetrators. iii) Under enforcement and insufficient monitoring of compliance with rules: Such a disadvantage is attributed to self regulators' conflicts of interest – as well as the level of flexibility at their disposal .

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[11] C Coglianese, T J. Healey, E K. Keating and M L. Michael, „The Role of Government in Corporate Governance" Regulatory Policy Program Center for Business and Government at page 6 http://www.ksg.harvard.edu/cbg/rpp/

[12] It is stated that „competitors will be able to effectively police each other's activities." see ibid

[13] see ibid at pages 7 and 8

Other disadvantages which could be attributed to self-regulation include:

i) Regulatory capture[14] (which will be discussed in greater detail under the second section of section C of the paper) – which could result from too much proximity and flexibility between the regulator and the industry and industries being regulated.

ii) Insufficient level of accountability

III. Advantages of Enforced Self Regulation over Self Regulation

In terms of flexibility, compliance, enforcement and accountability, the Enforced Self Regulation model is considered to confer greater benefits than self regulation.

"Enforced self regulation represents an extension and individualization of the "co-regulation." theory. Co regulation, as distinct from enforced self regulation, is usually taken to mean industry- association self regulation with some oversight and/or ratification by government."[15]

i) Monitoring, Compliance and Enforcement

In proposing that "the need for innovation is at the intermediate levels of the pyramid of regulatory strategies", Ayres and Braithwaite infer that the greatest challenge encountered by regulatory design is probably not to be found at the apex of the pyramid of regulatory strategies "where a variety of well-tested punitive strategies exist" or at the base of the pyramid, "where there is experience of the successes and failures of the free market and of self-regulation in protecting the consumers."[16]

As well as the fact that Enforced Self Regulation is considered to facilitate a process whereby "more offenders would be caught often", "offenders who are caught are thought to be disciplined in a larger proportion of cases under the Enforced Self Regulation Model than under traditional government regulation".[17]

According to the findings of a research undertaken by Barth, Caprio and Levine,[18] they conclude that regulatory practices which "involve direct government oversight of and restrictions on banks", such practices conforming with the grabbing hand view than the helping hand view of regulation, in their opinion, should be exercised with limitations and precautionary restraints.[19] Instead, practices which "compel accurate information disclosures, empower private-sector corporate control of banks, and foster incentives for private agents to exert corporate control" are recommended – given their potential to facilitate and promote bank stability.[20]

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[14] The theory of regulatory capture was introduced by Richard Posner who argued that „regulation is not about the public interest at all, but is a process, by which interest groups seek to promote their private interest.." See R Posner "Theories of Economic Regulation" (1974) 5 Bell Journal of Economics and Management Science at pages 335-358

[15] I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 102; Also see P Grabosky and J Braithwaite *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies*, (1986) at page 83 Oxford University Press, Melbourne.

[16] ibid at page 101

[17] See ibid at page 114

[18] R Barth, G Caprio Jr, and R Levine, "Bank Regulation and Supervision: What Works Best?" at page 1

[19] ibid

[20] ibid

Ayres and Braithwaite argue that "although internal compliance groups can be expected to catch more offenders than government inspectors, they cannot be counted on to send offenders to courts of law for prosecution with the frequency expected of government inspectors."[21] However, in their opinion, " reasons which suggest that enforcement under the Enforced Self Regulation model would not be less effective than a regime which exists under traditional government regulation include":

- The fact that under enforced self regulation, companies with strong records of disciplining their employees would be rewarded as showing up well in government audits of toughness of internal compliance systems;
- Existing public enforcement, in contrast, gives companies incentives to cover up and protect their guilty employees
- Internal discipline, is in many ways more potent than government prosecution because internal enforcers do not have to surmount the hurdle of proof beyond reasonable doubt, and do not have to cut through a conspiracy of diffused accountability within the organisation [22]
- It would be easier for prosecutors to obtain convictions under the Enforced Self regulation Model.[23]

- Compliance would become the path of least corporate resistance."[24]

However, they also add that direct government monitoring would still be required where firms are not able to afford their own internal monitoring compliance groups.

Barth et al, are of the opinion, however, that since banks are difficult and costly to monitor, given the fact that private agents may not have the ability or incentive to supervise banks – and hence, such agents will attempt to" free-ride", "the helping hand view" of government suggest an important, powerful role for government officials in regulation and supervision.[25] They are also of the view that government officials can mitigate market failures resulting from "sub optimal performance and stability" occasioned by insufficient monitoring.[26]

Under Enforced Self Regulation, greater compliance would be fostered, not only because "rules would be tailored to match the company – hence, i) rules could be simpler and have greater specificity of meaning, ii) the dangers of complexity and blandness may be avoided when rules relate to a finite and known set of circumstances rather than to an infinite and unknown range of business activities, but also because companies would be more committed to rules they wrote."[27]

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[21] I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 114

[22] In this regards Ayres and Braithwaite make reference to the fact that "corporations in the past have protected their individual members from prosecution by presenting a confused picture of the allocation of responsibilities to the outside world"; see ibid

[23] see ibid at page 115

[24] "Requiring compliance directors to report management refusals to heed their recommendations would put pressure on executives to comply with those recommendations; ibid

[25] R Barth, G Caprio Jr, and R Levine, "Bank Regulation and Supervision: What Works Best?" at page 11

[26] ibid

[27] I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 110. Furthermore, Ayres and Braithwaite add that any attempt to "pass on the buck" could be mitigated through joint participation of company, government, and stakeholders in a rule making programme. See ibid at page 113

ii) Accountability

Although the Enforced Self Regulation model is considered to offer greater possibilities whereby corporate agents could be held accountable – than is the case under self regulation, there is greater scope for such a model to be optimised as will be considered under the model which incorporates both Enforced Self Regulation and Regulatory Competition.

iii) Flexibility

The flexibility conferred by the Enforced Self Regulation model could also help address the control of corporate crime since it is also contended[28] that "a primary reason for the failure of the law to control corporate crime" stems from the fact that "legal institutions are made to last, whereas economic institutions are designed for rapid adaptation to changing economic and technological realities" - and that as a result, "rules would adjust more quickly to changing business environments".

iv)Avoiding Duplication

Reference is also made to the fact that "government regulation of prices and profits of private concerns always involves a large element of waste, duplication and costs – since two sets of persons are concerning themselves with the same work."[29]

B. The Influence of Banks on Firm Performance and Accountability in Stock Market Economies, and Universal Banking Systems

"If banks improve performance with respect to their own holdings, why do they not use their proxy power to further improve firm performance?"[30]

Characteristics attributed to banks, which to an extent, are distinguished on the basis of whether such banks operate or exist in stock market economies or universal banking systems include the fact that:[31]

- Banks in stock market economies are considered to assume roles which include those of "monitoring managements" – this occurring through the bank acting principally as a creditor

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[28] see I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 110. In this context, Ayres and Braithwaite also add that "rules would be tailored to match the company" and that under enforced self regulation, "rules could be both simpler and have greater specificity of meaning. The dangers of complexity and blandness may be avoided when rules relate to a finite and known set of circumstances rather than to an infinite and unknown range of business activities"; ibid.

[29] See A Pigou, *The Economics of Welfare* Volume 1 2005 at page 379 : Alfred (not Arthur!) Pigou makes reference to Professor Durand's observations in this statement.

[30]The response given to their question is that "firstly if banks were to use their power overtly (even for the good), social sanctions may be imposed on them. Secondly, bank power is limited by the ability of individuals to dictate to banks on how they should vote." see G Gorton and F Schmid, „Universal Banking and the Performance of German Firms" NBER Working Paper 5453 1996 at page 25.

[31] Ibid at page 1

- In the case of universal banking systems, banks are authorised to “underwrite, trade, hold firms’ equity. Furthermore, since the capitalisation of the stock market is small, hostile take-overs rarely occur.”

The above distinctions between stock market economies, as well as other differences[32], in Gorton and Schmid’s opinion, give rise to questions, one of which relates to accountability – namely, “how agency problems between managers and shareholders are dealt with in Germany where there is a separation of ownership and control (given the absence of a large stock market). If shares are not easily traded how are managers held accountable?”[33]

Such concerns however, may prove to be unfounded. The universal banking system which operates in Germany is distinguished from the stock market economies which exist in the US and the UK, and with respect to governance, on the basis that there is less dispersed ownership and higher concentration of ownership of larger firms in Germany.[34] In countries like the UK and the US where ownership is more dispersed, it is argued that “control is exerted by managers with considerable freedom to pursue their own interests at the shareholders’ expense” – since their actions are not monitored adequately.[35] It is also argued that there is little incentive for individual shareholders to monitor since they are individually responsible for any accrued costs – even though such monitoring ultimately serves the benefit of all shareholders.[36]

Hence whilst there are concerns related to accountability - in respect of agency problems between managers and shareholders and given the absence of large stock markets, the presence of less dispersed ownership and a higher concentration of ownership of large firms in such jurisdictions as Germany could serve to compensate as checks in holding managers of such firms accountable for their actions (since there will be less likelihood for such managers to pursue their own interests). Conversely, the presence of large stock markets in the UK and US could compensate for a gap in accountability mechanisms which is attributed to more dispersed ownership within these jurisdictions.

Other questions relate to how information is to be transmitted to German firms involved in decision making procedures (related to investments) in the absence of stock market prices and whether banks act to resolve agency problems in firms or rather serve as detrimental factors to the performance of firms .[37]

Furthermore, Xie concludes[38] that “the overall effect of universal banking on firm growth is negative” – with the suggestion that the negative effect attributed to conflicts of interest dominates the positive effect attributed to economies of scale and scope of universal banking.

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32 For further differences, see ibid at page 1

33 ibid at page 2

34 See J Edwards and M Nibler, „Corporate Governance in Germany: The Role of Banks and Ownership Concentration“ 2000 Journal of Economic Policy Volume 31 at pages 237-260

35 ibid at pages 239 and 240

36 ibid

37 In this regard, they pose the fundamental question of “whether a relationship with a German bank serves as a substitute for a stock market.”

38 See L Xie, “Universal Banking, Conflicts of Interest and Firm Growth” 2007 at page 1: Refer to abstract of the paper

It is also highlighted that “a banking system dominated by state owned banks may be associated with lower firm performance.”[39]

The ability of commercial banks to conduct business activities involving securities, it is argued, could impact firm performance in two contrasting ways, namely:[40]

- Economies of scope and scale in universal banking can facilitate firms’ access to credit and promote firm growth. In addition, economies of scale in universal banking which allows better risk diversification and lowers transaction costs for banks, could also result in higher levels of growth for the firm.

- On the other hand, a combination of commercial banking and securities business could also introduce the possibility of conflicts of interest, creating disincentives for firms and lowering firm growth.”[41]

C. Conflicts of Interest Attributed to Asymmetric Information

The above mentioned conflicts of interest, it is further argued[42], could also adversely impact the levels of bank monitoring – given the fact that firms would expect to be bailed out during periods of distress and difficulties.

Having highlighted the potential of asymmetric information to facilitate conflicts of interest, systemic risk and market failures which are also generated as a result of such asymmetries call for stronger measures aimed at facilitating the exchange and disclosure of information between the industry being regulated and the regulator/s. This also justifies roles for government, private agents and other actors in regulation since the involvement of more actors would mitigate possibilities whereby excessive concentration of information in the hands of a particular actor could occur. The greater the number of actors involved in the regulatory process, the greater the possibilities that information would be distributed to a greater extent between parties involved. Furthermore, where more actors are involved, there should less scope for abuse of information , more checks to ensure that certain actors do not use such information for their personal or political gains, and less possibilities of “regulatory capture” occurring.

Regulatory Capture

The independence of the regulator from the industry which is being regulated is vital to ensuring that regulatory capture does not occur. Regulatory capture is less likely to occur

[39] ibid at page 9; “Unrestricted” range of security business and “permitted” range of security business are distinguished in the sense that “unrestricted” is used to denote the fact that a “full range of securities activities” can be conducted directly in the bank (an example of this being the universal banking system which operates in Germany – where commercial banks are allowed to conduct a full range of securities business in-house) whilst “permitted” is used to refer to the fact that “a full range of securities activities can be conducted but all or some must be conducted in subsidiaries.” See ibid at page 16

[40] L Xie, “Universal Banking, Conflicts of Interest and Firm Growth” 2007 at page 3

[41] In this sense Xie uses universal banking interchangeably with the combination of commercial banking activities and securities businesses. See ibid at page 2. She adds that “more specifically, if banks are able to underwrite securities for their borrowing firms, they may have incentives to help firms issue securities by hiding or distorting information when firm quality has deteriorated and credit risk levels have increased.” (such information relating to quality deterioration and credit risk being known only to such banks).

[42] Ibid at page 3

where more actors are involved in the regulatory process and is more likely to occur where there is regular contact between the regulator and the regulated.[43] As well as being consequential of a lack of transparency in the supervisory regime, regulatory capture is also more likely to occur where a system of self regulation exists. In elaborating on the role of government in preventing banks from taking excessive risks, the crucial issue to be addressed relates to the facilitation of information disclosure.

"The economic theory of regulation as proposed by Stigler admits the possibility of "capture" by interest groups other than the regulated firms. Furthermore, exceptions to the general rule that regulatory agencies are captured by the regulated firms are explained by references to the personality of the legislators, public opinion, ignorance, folk wisdom etc."[44] Posner also provides criticisms of both the traditional public interest theory of regulation and "the newer economic theory" which regards regulation as "a service supplied to effective political interest groups."[45]

As mentioned above, the greater the number of actors involved in the regulatory process, the lesser the probabilities of regulatory capture occurring. Furthermore, possible conflicts of interest which could occur between banks and their shareholders, between the Government and the firms which are being regulated by regulator would be mitigated where other actors which are independent from the firms, banks or the Government, are involved.[46] Do mechanisms of accountability (such as groups which serve the interests of practitioners, consumers etc) prevent regulatory capture? The answer to this would appear to be in the affirmative but could also appear in the negative – dependent on how much influence such an accountability mechanism has on the regulator. Even though the Consumer Panel provides advice to the Financial Services Authority (FSA), some form of check is in place to ensure that it does not unduly influence the regulator by restricting its main purpose to the provision of advice. It does not carry out responsibilities on behalf of the FSA.

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43 Characteristics of situations where regulatory capture is likely to occur include: i)" Where only one industry is being regulated; ii) where the regulator is part of a larger organisation; iii) where there is conflict between the regulator and the regulated ; iv) where regular contact occurs between the regulator and the regulated and/or ; v) where a regular exchange of personnel occurs between the regulator and the regulated." See P Grabosky and J Braithwaite (1986) *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* Oxford University Press

44 See R Posner "Theories of Economic Regulation" (1974) 5 Bell Journal of Economics and Management Science at pages 343 and 344.

45 Ibid at page 356

46 "The Financial Services Markets Act 2000 established the Practitioner Panel as a statutory body alongside the Consumer Panel and the Financial Services Consumer Panel advises the FSA on all aspects of its work – at the same time monitoring its effectiveness from a consumer's perspective". See " The Financial Services Practitioner Panel : Statutory Role" http://www.fs-pp.org.uk/stat_role.htm and "The Financial Services Consumer Panel: An Independent Voice for Consumers of Financial Services" (Annual Report 2004/2005) at page 1

"With regards to public accountability, the Financial Services Authority (FSA) is obliged to maintain arrangements for consultation with consumers and practitioners. There were concerns that the independence of the Practitioner and Consumer panels would be compromised since they were established by the FSA – however statutory roles were given to both panels. Section 11 of the Financial Services and Markets Act 2000 brought an important part of formal accountability of the FSA to the Panel into effect. The FSA is required to consult both panels about how far its general policies and practices conform to its statutory duties – such a statutory obligation also embracing its regulatory objectives and principles." For further information on this see C Hadjiemmanuil, *Banking Regulation and the Bank of England* 1995 at page 404 (Lloyds of London Press) and M Ojo, "The Financial Services Authority: A Model of Improved Accountability" Global Journal of Business Research (2007) Volume 1No 1 at pages 83 - 96

D. Government Ownership of Banks

Two proposed views of governments' involvement in financial markets are as follows:[47] the first, referred to as the "development" view, is linked to Alexander Gerschenkron who is considered to have placed focal attention on the importance of financial development – as a means of facilitating economic growth. He argues that privately owned commercial banks were the crucial vehicle of directing savings to the industry in several industries – most notably, in Germany. In contrast, the second and more "current" political view of government ownership advanced by La Porta et al is one whereby "government control of finance, through its banks or otherwise, politicises resource allocation for the sake of getting votes or bribes for office holders."[48] This second and more pessimistic view is also considered to lower economic efficiency.[49]

Ways through which the government is considered to be involved in the financing of firms include:[50]

- Through the direct provision of subsidies
- By encouraging private banks through regulation and suasion to lend to politically desirable projects

Government ownership of banks, in contrast to its regulation of the industry or "outright ownership of all projects", it is argued, not only provides government with "extensive control over the choice of projects being financed whilst leaving the implementation of these projects to the private sector," but also enables it to address and rectify institutional failures which pose a threat to private capital markets – hence serving as a tool which such a government could implement in facilitating financial and economic growth.[51] In Germany and France - where the financial sector was dominated by state ownership[52], as globalisation gained momentum , the issue of asymmetric distribution of information between the industry being regulated and the primary regulator was considered not to be as important[53] as was the case with the UK, Japan and North America.

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47 See R La Porta, F Lopez – de Silanes and A Shleifer "Government Ownership of Banks" 2000 Working Paper 7620 http://www.nber.org/papers/w7620 at page 3

48 ibid at page 4

49 ibid

50 ibid at page 5

51 ibid

52 Based on data relating to share of the assets of the top 10 banks owned or controlled by the government (government ownership of banks of these countries in 1995), such data revealed that government ownership of banks in France amounted to 17.26% whilst that for Germany amounted to 36.36%. Based on data relating to the share of assets of the top 10 banks owned or controlled by the government in 1985 – using as proxy for the percentage of banking assets owned by the government before the privatisation in the 1960s and 1970s, such data revealed that government ownership of banks before privatisation in France amounted to 75% whilst that for Germany amounted to 36.36%. See R La Porta, F Lopez – de Silanes and A Shleifer "Government Ownership of Banks" 2000 Working Paper 7620 http://www.nber.org/papers/w7620 at pages 36 and 37

53 The issue of asymmetry was not as important since banks were the dominant institutions in their countries – due to their universal bank structure; see JR Shelton, The OECD Report on Regulatory Reform 1997 Volume 1: Sectoral Studies at page 73-74

b) Role of State Regulation in Helping to Prevent Banks from Taking Excessive Risks – Addressing Asymmetric Information

The moral hazard rationale for regulation is attributed to safety net arrangements such as deposit insurance and lender of last resort arrangements.[54] Lender of last resort arrangements could have adverse incentive effects and induce banks into excessive risk taking whilst deposit insurance protection could lead to consumers being less careful about their selection of banks.[55] Furthermore, because of insurance, some depositors do not demand an appropriate risk premium in their interest rates and finally, the existence of deposit insurance may compel banks to hold lower levels of capital.[56]

Apart from good regulatory procedures and the design of regulation to the effect that it discourages inadequate pricing of insurance premiums (which would stimulate incentives of bank managers to take excessively undue risks), other ways through which moral hazard could be controlled include good corporate governance practices and effective disclosure requirements under which banks are mandated to disclose information to users of that information.

An important means whereby corporate responsibility, through banks, could be enhanced, relates to measures which could be imposed to reduce excessive levels of risk taking by banks – as well as stimulating depositors' incentives to monitor banks. Bonus related schemes which are linked to performance levels of bank's senior management, and which will be reduced or refused, based on the level of negligence, recklessness or irresponsibility of such officials, could be imposed. In relation to levels of deposit insurance which is offered to their customers, levels granted (as well as being dependent on the deposited amount), should correspond with the number of years that a depositor has held an account with a bank. A customer who has deposited considerable huge amounts with a bank, and who has been a long standing customer of a bank is generally more likely to monitor such bank's activities than a customer who has very little reason to. There should be no guarantee that all depositors (long standing and newly acquired) will receive the same and guaranteed level of protection). Loyalty to a bank – as evidenced by, and dependent on amounts deposited, as well as the length of time spent as a depositor with such a bank, should be compensated monetarily since such depositors are considered to be taking some level of risk and should assume some form of responsibility in monitoring the actions of those into whose hands they've committed their deposits.

"Without regulation which gives consumers some independent assurance about the terms on which their contracts are offered, quality of advice received, saving and investment is discouraged resulting to damaging consequences. In addition, healthy competition will be fostered through consumer education and disclosures of information on charges and other important characteristics of financial products."[57]

Greater disclosure of information would not only facilitate monitoring and compliance, but would also help mitigate informational asymmetries which exist between a bank's management and its investors. In highlighting the role of the "helping hand view" of

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[54] See D Llewellyn, "The Economic Rationale for Financial Regulation" (FSA London Occasional Paper 1 April 1999) at page 29

[55] ibid

[56] ibid

[57] See speech by Howard Davies, former chairman of the Financial Services Authority „Building the FSA – Progress to Date and Priorities Ahead."

government, Barth et al argue that government supervision has the potential to perform a "socially efficient role" since informational asymmetries is considered by some to be a reason why banks are susceptible to "contagious and socially costly bank runs."[58]

E. Bank Independence from External Control versus Government Ownership of Banks

Several arguments have been put forward for and against the independence of banks from external control. Whilst critics of the universal banking system regard a concentration of power in banks as detrimental (given the potential conflicts of interest which may occur where bank "is simultaneously an important large equity holder in the firm, in control of a large number of proxy votes, controls access to external capital markets, and has outstanding loans to the firm") – such concentration of power facilitating the ability of the bank to run firms for their personal gains and interests,[59] arguments in support of German banks "as a model of active shareholders which should be emulated in stock market based economies" do not only suggest that the universal banking system provides a system whereby banks are "active, large investors which improve the performance of firms to the extent that they hold equity and have proxy voting power", but that banks in such systems are considered to be "long –term investors who oversee firm investments and organize internal capital markets."

Different views are also held in relation to government ownership of banks. With particular reference to the impact of government ownership of banks on financial development (as well as the stability of the financial system), "whilst the helping hand view argues that i) government ownership of banks fosters the mobilization of savings and the allocation of those savings towards strategic projects with long term benefits on the economy; ii) that governments have adequate information and sufficient incentives to ensure socially desirable investments; and ii) that consequently government ownership of banks helps economies to overcome private capital market failure",

the grabbing hand view argues that i) "governments do not have sufficient incentives to ensure socially desirable investments; ii) whilst government ownership of banks may facilitate the financing of politically attractive projects, that such projects may not necessarily be economically efficient."[60]

Drawing back on Dowd's criticism that market failures related to information asymmetry are not really genuine given the fact that they are founded on governments' failures (moral hazard created by regulatory authorities themselves)[61], and the need for government to price deposit insurance premiums adequately, such inadequacies in government regulation and the inadequacies also attributed to private regulation add weight to Ayres and Braithwaite's idea of "the need to transcend the intellectual stalemate between those who favour state regulation of business and those who advocate deregulation."[62]

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58 R Barth, G Caprio Jr, and R Levine, "Bank Regulation and Supervision: What Works Best?" at page 11

59 G Gorton and F Schmid, „Universal Banking and the Performance of German Firms" NBER Working Paper 5453 1996 at page 2

60 R Barth, G Caprio Jr, and R Levine, "Bank Regulation and Supervision: What Works Best?" at page 14

61 K Dowd, "Does Asymmetric Information Justify Bank Capital Adequacy Regulation?" Cato Journal Volume 19 No 1 1999 at page 40; see also D Miles, ''Optimal Regulation of Deposit Taking Financial Intermediaries'' (1995) European Economic Review 39: 1365–84.

62 I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 3; "The basic idea of responsive regulation being that governments should be responsive to the conduct of those they seek to regulate in deciding whether a more or less interventionist response is needed." See J Braithwaite, *Restorative Justice and Responsive Regulation* (2002) at page 29

F. Co-operative and Competitive Enforced Self Regulation

A combination of the Enforced Self Regulation model and a model which incorporates regulatory competition into Basel II (meta regulation), that is, a combination of the Enforced Self Regulation model and the regulation of self regulation (which incorporates attributes of regulatory competition), - such a model being referred to as Cooperative and Competitive[63] Enforced Self Regulation, will be considered under this section.

In comparing and contrasting advantages and disadvantages associated with regulatory competition to those associated with Enforced Self Regulation and how these could complement each other to address disadvantages attributed to self regulation, it will also be illustrated under this section, that a model based on Co-operative and Competitive Enforced Self Regulation not only offers greater flexibility, but also more accountability mechanisms which would facilitate compliance.

I. Advantages of Regulatory Competition

a) Accountability

Whilst the firm is subject to mandatory regulations under the Enforced Self Regulation model, it is also subjected to a second level of regulation under Basel II – which serves as an additional check on the self regulatory processes undertaken by the firm.

Such a model is represented diagrammatically below:

Basel Committee-----→ Meta Regulation --→ **State** ---→ Enforced Self Regulation --→ **Firm**

Other actors involved in the model could include trade associations and bodies which represent industry and consumer interests, and non governmental organisations. As illustrated with the Practitioner and Consumer Panels under section C of this paper, the involvement of these actors would not only serve as accountability mechanisms, but also have the potential to mitigate situations where asymmetric distribution of information could occur. It could also reduce the likelihood of a "capture" occurring – given that the regulator is not overly influenced by these accountability mechanisms and "checks".

Enforced Self Regulation (in the form of binding regulations) is required – not only because the Basel Committee is in need of stronger enforcement mechanisms, but because the "race to bottom effects" attributed to unfettered regulatory competition needs to be addressed.

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[63] A combination of co operation and competition rather than mere competition is preferred for reasons which will be discussed in greater detail under the last but one section of this paper (that is, under section titled "Does Regulatory Competition Always Generate "Race to the Bottom" Effects ?"). Such a combination provides greater maximisation potential for regulatory competition as it mitigates possibilities of "race to the bottom" effects.

b. Binding Regulations Contrasted with Regulations Under Regulatory Competition

Greater Flexibility Attributed to Regulatory Competition

Whilst some apparent advantages are associated with binding and mandatory regulations, the disadvantage inherent in mandatory regulation – when compared with the form of regulation synonymous with regulatory competition, is namely, the fact that mandatory regulation does not provide the choice of legal regimes which is offered to market participants under the theory of regulatory competition. It is contended that mandatory regulation, by compelling market participants to comply with a legal regime, generates "sub-optimal" benefits whilst the availability of choice accorded to the theory of regulatory competition, provides the potential to facilitate optimal regulation.[64]

Regulatory competition also offers flexibility in facilitating the modification of regulations - which not only helps in "optimally matching the interests of those that bear the cost and incur the benefit of regulation," but also helps regulators in facilitating more superior regulation.[65]

II. Other Advantages Attributed to Regulatory Competition

As well as providing an apparent benefit over a single regulator – given the fact that it aligns (with greater accuracy), the incentives of regulators and issuers with perspectives of investors (thereby facilitating greater likelihood of generating rules which are preferred by investors),[66]other benefits attributed to the theory of regulatory competition include:

i)Regulatory competition permits the creation of a single market without requiring member states to give up their regulatory power.[67]

ii)Regulatory competition is also considered to facilitate experimentation which fosters the innovation of policies – owing to the fact that cross border activities and the setting up of firms across national boundaries triggers regulators' incentives to modify their regimes.[68]

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[64] EJ Pan, „Harmonization of U.S – E.U Securities Regulation: The Case for a Single European Securities Regulator". Law and Policy in International Business at page 3 FindArticles.com http://findarticles.com/p/articles/mi_qa3791/is_200301/ai_n9192864/
[65] EJ Pan, „Harmonization of U.S – E.U Securities Regulation: The Case for a Single European Securities Regulator". Law and Policy in International Business at page 3
[66] See R Romano, "Is Regulatory Competition a Problem or Irrelevant for Corporate Governance ?" March 2005 ECGI Law Working Paper Series Working Paper No 26/2005 at page 9. Such a benefit, it is contended, draws from the fact that "issuers will be attracted to a regime preferred by investors in order to lower their cost of capital."
[67] EJ Pan, „Harmonization of U.S – E.U Securities Regulation: The Case for a Single European Securities Regulator". Law and Policy in International Business at page 3
[68] R Romano, "Is Regulatory Competition a Problem or Irrelevant for Corporate Governance ?" March 2005 ECGI Law Working Paper Series Working Paper No 26/2005 at page 10. Such incentives, which are considered to be triggered as a result of the regulator's desire "to attract and retain firms within their jurisdictions, may be financial." ;ibid

III. Principal Disadvantage Attributed to Regulatory Competition

The most compelling disadvantage associated with regulatory competition is attributed to its contribution to "downward pressures on regulation".[69] The "race to the bottom" effect generated by regulatory competition , whereby the "level of protection for shareholders, employees, customers and the general public is progressively lowered", is associated with the "Delaware effect"- a "deregulatory dynamic."[70] Such unfettered regulatory competition, whereby regulators , in competing for their interests, minimise rules to such an extent that the resulting outcome and benefits generated by such rules are minimal than required, constitutes a reason for the preference for "regulatory co-optition".[71] "Optimal governance", it is contended, "requires a flexible mix of competition and co operation between governmental actors, as well as between governmental and non governmental actors."[72]

IV. Does Regulatory Competition Always Generate "Race to the Bottom" Effects ?

In contrast to the criticism attributed to regulatory competition's "race to the bottom" effects, reference has been made to the fact that "regulatory competition does not necessarily result in downward pressures on regulation but may sometimes also push the level of regulation upwards."[73]Furthermore, Genschel and Plümper argue that upward pressure on regulation may not only result from competitive dynamics, but could also be triggered as a result of international co operation. In their paper[74], they investigate whether the effects of the deregulatory spiral which is attributed to regulatory competition could be successfully mitigated or eliminated as a result of the collective action of competing states (who are able to stop such competition as a result of a successful "co-operative turnaround").

Their investigation focuses on the harmonization of capital adequacy requirements, through Basel II, which in their view, illustrates the fact that "multilateral co-operation among nation states can stop a deregulatory spiral and turn it around to a race to the top."[75] They also

[69] See P Genschel and T Plümper, „Regulatory Competition and International Co operation" December 1997 Journal of European Public Policy Volume 4 No 4 at page 626

[70] see ibid .In illustrating this deregulatory process, an example is provided with corporate chartering in the U.S – where such chartering was granted by the individual states. Since all states were required to recognise each other's charters, competition occurred between states who were striving to acquire corporations through the provision of "corporation friendly chartering requirements." Such a process is known to contribute to a lowering of the level of protection for shareholders, employees, customers and the general public; ibid

[71] EJ Pan, „Harmonization of U.S – E.U Securities Regulation: The Case for a Single European Securities Regulator". Law and Policy in International Business at page 4

[72] See DC Esty and D Geradin, „Regulatory Competition and Economic Integration: Comparative Perspectives" 2001 Oxford University Press at page 31

[73] See P Genschel and T Plümper, „Regulatory Competition and International Co operation" December 1997 Journal of European Public Policy Volume 4 No 4 at page 627. In this respect, reference is made by Genschel and Plümper to Vogel illustrations from his book: see D Vogel, *Trading Up: Consumer and Environmental Regulation in a Global Economy*, (1995) Cambridge MA: Harvard University Press

[74] See ibid

[75] ibid; Their first case study highlighted why co operation was self stimulating whilst the second highlighted why co operation was self limiting.; see ibid at page 639. In drawing similarities between both cases, namely the fact that both dealt with a collective action problem, an extension of the range of co-operators was proposed as a means of resolving the problem of collective action: "as more and more actors join the co-operation, there are fewer and fewer actors left who could potentially free ride." See ibid at page 634. Also see L Martin "The Rational State Choice of Multi lateralism" in John Gerard Ruggie (ed) *Multi lateralism Matters: The Theory and Praxis of an Institutional Form* (1993) New York: Columbia University Press at pages 98-100. As a means of resolving problems associated with interest heterogeneity, a contrasting proposal is put forward by Genschel and Plümper who state that it is useful to limit the range of co-operators. Furthermore, the search for a balance

highlight the fact that strict rules should not necessarily infer consequences of competitive disadvantage and that "competitive dynamics", as well as international co-operation, could also trigger a process whereby foreign governments react by raising their own level of regulation – hence starting a regulatory race to the top.[76]

Whilst Basel II's ability to facilitate a situation whereby governments are induced to raise their level of regulation is doubtful, given its relatively weak enforcement mechanisms, its capacity to facilitate multi lateral co operation – hence deterring a deregulatory spiral, is acknowledged.

G. Conclusion

As mentioned in a previous paper[77], justification for greater enforcement with Basel II (than is presently the case), arises from the fact that whilst state imposed rules (as exemplified under the Enforced Self Regulation model) are obligatory, Basel II rules are persuasive by nature. If the Co-operative and Competitive Enforced Self Regulation model is to realise maximum benefits, the Basel Committee will require greater powers of enforcement. Although Basel II and regulatory competition both facilitate market based regulation and harmonisation, once a state has opted to be bound by rules under Basel, such rules should be enforced in their entirety.

Whilst direct government monitoring may sometimes be required where certain firms are unable to afford their own internal monitoring devices, such direct government oversight may require caution since practices which involve direct government oversight are also considered (by some) to conform with the "grabbing hand" theory. Practices which facilitate accurate information disclosures are primarily recommended.

The Co-operative and Competitive Enforced Self Regulation model would facilitate greater accountability, corporate responsibility, flexibility, disclosure and innovation than self regulation or the model based on Enforced Self Regulation. Furthermore, it would foster harmonisation between countries, as well as mitigate the effects attributed to a "race to the bottom" – hence generating possibilities of a regulatory "race to the top".

The involvement of actors such as governments, private actors, trade associations, non governmental organisations and other interest groups in the regulatory process could have consequences which may be beneficial or detrimental – depending on the interests being pursued, the effectiveness of accountability mechanisms in the regulatory process and the number and mix of actors involved. As stated in the introductory paragraph of the paper, a combination and flexible mix of co-operation and competition between various actors

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between inclusiveness and exclusiveness is suggested as a way of resolving both problems at once (the problems attributed to collective action and the interest homogeneity). See P Genschel and T Plümper, „Regulatory Competition and International Co operation" December 1997 Journal of European Public Policy at page 635. Also see P Genschel and T Plümper, "Wenn Reden Silber und Handeln Gold ist: Kooperation und Kommunikation in der internationalen Bankenregulierung" Zeitschrift für Internationale Beziehungen 3:225-253 and R O Keohane, „Multi lateralism: An Agenda For Research" International Journal Volume 45 No 4 at pages 731 - 764

[76] P Genschel and T Plümper, „Regulatory Competition and International Co operation" December 1997 Journal of European Public Policy Volume 4 No 4 at page 627; With their second case study, Genschel and Plümper illustrate the failure of the European Community (EC) "to counter tax competition by agreeing on a common withholding tax on interest payments" and in so doing , ideas as to when cooperative turnarounds are likely to fail.

[77] See M Ojo, „The Impact of Capital and Disclosure Requirements on Risks and Risk Taking Incentives" February 2010

provides essential ingredients to achieving an optimal system of governance. It would also be added that such an optimal mix also requires effective mechanisms of accountability and enforcement.

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